

The advantages of structuring PRC investments through Hong Kong

Leo Seewald
Goodmans

Introduction

China's position as the number one destination for foreign investment will likely remain intact for quite some time. Foreign companies are jockeying for position on where to best set up their operations in China: Beijing? Shanghai? Guangzhou? In all the activity, many companies are forgetting about the original gateway to the People's Republic of China (PRC): Hong Kong. This article looks at a number of reasons of why Hong Kong remains one of the best entry points for any company wanting to set up business in China.

A brief history

When China opened to the world economy in 1978, Hong Kong was its only doorway to the West. As part of its opening initiative, China designated three 'special economic zones' where foreign investment could be made and all of these zones were located in the Southern part of China.¹ Hong Kong quickly became the conduit through which China exported to the world, causing Hong Kong to grow into the business and finance centre that it is today.² It should not be surprising that to this day, Hong Kong remains China's number-one trading partner.

The Chinese government has gradually liberalised its trading policies and allows (and even encourages) foreign investment to invest directly into all regions of the country.³ In response, many companies now invest directly in China, having forgotten (or even unaware of) the benefits of structuring an investment through Hong Kong. Structuring an investment through Hong Kong means, at a minimum, setting up a holding company in Hong Kong and using that holding company to establish the operating company in China.⁴ At a maximum, it means setting up a regional headquarters in Hong Kong and using it to establish and control the operating company in China.

The benefits

First, it is important to emphasise that Hong Kong is again part of China. While this point is obvious enough, it has important implications. Hong Kong and the mainland⁵ maintain what is called a 'one country, two systems' policy.⁶ Under this system, the Chinese government has promised that Hong Kong will maintain its unique economic and legal systems.⁷ Thus, from a legal perspective, 'one country, two systems' means that Hong Kong continues to use English Common Law as its foundation. From an investment perspective, 'one country, two systems' means that Hong Kong now benefits from being part of China (the Chinese government has correspondingly granted a number of concessions to Hong Kong resident business, which will be discussed below). It also means that Hong Kong has been able to maintain a number of the economic and structural benefits that it had prior to 1997, including its market economy,⁸ low taxes and an efficient bureaucracy.

In a North American context, Hong Kong's role in developing a foreign company's investment strategy for China is perhaps most eas-

ily explained by comparing it to the US jurisdiction of Delaware. Delaware has for years been the preferred location for incorporating a company in the US because of its sophisticated commercial law and lower tax rates. In the same way, of all the regions of greater China, Hong Kong has the most sophisticated legal system and the lowest standard corporate tax rates. It is for this reason that Hong Kong, like Delaware, has the most corporate headquarters in the region. Having stated this, even if the intention is not to establish a regional headquarters, many of these benefits can be had by using a Hong Kong holding company to hold the shares of the proposed PRC joint venture (JV) or wholly foreign-owned enterprise (WFOE).

Tax benefits

Hong Kong also has the lowest corporate income tax rate in China at 17.5 per cent. In comparison, the PRC has a standard corporate income tax rate of 33 per cent.⁹ By using transfer-pricing techniques, a PRC foreign-owned factory can sell its products to its Hong Kong holding company at a low price, which in turn can sell the products to third-party foreign customers at a higher price.¹⁰ By this means, a larger portion of the profits can be realised in Hong Kong and will therefore be taxed at the lower Hong Kong rate.

In terms of the repatriation of profits from the foreign company's perspective, the repatriation of profits from China to the foreign jurisdiction is generally the same whether the profits flow directly from the PRC entity or through a Hong Kong intermediary.¹¹ The foreign parent company with a Hong Kong holding company, therefore, has the option of keeping the profits in Hong Kong; such funds can be reinvested for other offshore purposes by the Hong Kong company.

Legal system benefits

A JV or WFOE established in China, will, of course, be subject to PRC law. If a Hong Kong holding company is used, agreements with third parties can be signed by the Hong Kong holding company which will be governed by Hong Kong law. Companies may find that new customers may also take comfort in the fact that agreements are signed in Hong Kong as opposed to China, as Hong Kong is seen as a lower risk jurisdiction.

Hong Kong's legal system remains based on the rule of law. Its courts are independent of the government and are open to the public. In Hong Kong, both English and Chinese are official languages, so all laws are also in English and all legal proceedings can at the party's request be held in English. This is not the case in the PRC where Chinese is the only official language in the PRC courts and English translations of laws are for reference. Another unique opportunity may soon arise as Hong Kong; the mainland authorities are currently negotiating a reciprocal enforcement of judgements agreement that, when adopted, will be an additional advantage to executing contracts in Hong Kong.¹² The result will be that Hong Kong judgements, unlike those of any other jurisdiction, will be recognised and immediately enforceable in the PRC.

Restructuring benefits

Using a Hong Kong holding company also affords greater flexibility in the case of restructuring the mainland entity. Transfers of ownership in a PRC entity, whether it is a JV or WFOE requires governmental approval, which can be time-consuming. Transfers of ownership of Hong Kong companies do not require approval and can be done immediately. Thus, if the intention is to sell 50 per cent of a WFOE and the foreign party holds the WFOE through a Hong Kong subsidiary (instead of directly), it can instead sell 50 per cent of the shares of its Hong Kong company. The purchase and sale agreement, as well as any subsequent joint venture agreement with the new 50 per cent shareholder, would be governed by Hong Kong law rather than PRC law. No approval is required for the transfer of shares in Hong Kong and no vetting of such joint venture agreement would be required.

Another benefit is that transfer tax must be paid for the transfer of an interest in a PRC entity, whereas Hong Kong only levies a 0.02 per cent (on net asset value) 'stamp duty' on the transfer of shares. The result is that a foreign company that wishes to sell or restructure its holdings in a PRC entity can do so much more easily and quickly if it has the option of carrying out such sale or restructuring at the Hong Kong holding company rather than at the PRC company level.

Liability issues

Inserting a holding company between the parent and the WFOE also affords the parent company some protection from liability. On the mainland, the corporate veil is lifted much more easily than in western jurisdictions. By using a holding company between the foreign parent company and its PRC WFOE or JV, the foreign company can insulate itself to some degree if problems arise at the WFOE or JV level. In this situation, the Hong Kong holding company will be held responsible rather than the foreign parent company.

Ease of registration

One other simple advantage of using a Hong Kong company is that Chinese authorities are very familiar with Hong Kong companies and Hong Kong corporate documents (not to mention the fact that Hong Kong companies can be established with both Chinese and English articles of association). Both upon the set up and at certain other times, the WFOE or JV will be required to submit the corporate documents of its parent company to the PRC authorities. If the parent company is a Hong Kong company, the local PRC authorities will recognise the documents and will have an easier time processing them than would be the case for jurisdictions they have less exposure to. This makes the incorporation process (and to a more limited extent the ongoing operation) of the PRC entity more efficient.

Benefits granted by PRC government

In the last number of years there has been a concerted effort by the PRC government to integrate the economy of Hong Kong into China (particularly with the so-called 'Pearl River Delta'¹³). The Chinese government has actively looked at ways to make it easier for Hong Kong companies to do business in China. The most obvious example of this is the so-called 'Closer Economic Partnership Agreement' (CEPA) that was signed between Hong Kong and the mainland on 29 June 2003.

CEPA – manufacturing

Starting in January 2004, China eliminated tariffs on 273 categories of goods exported from Hong Kong to China. In total, these categories make up 90 per cent of the goods exported to China. The requirement is, however, that the goods must be of "Hong Kong Origin", meaning they must meet the CEPA rules of origin.¹⁴ It was also

agreed that for all other products of Hong Kong origin, no tariffs will be applied after 1 January 2006.

While no-one expects Hong Kong to become the manufacturing centre it once was, there are certain unique opportunities that arise through CEPA. For example, companies that establish factories in China can move some of the specialised manufacturing processes to Hong Kong, where they can carry out some of the more delicate processes and then distribute the product back in the mainland. They may also consider moving production of some of the company's more sensitive intellectual property products to Hong Kong, as IP protection is more stringent in Hong Kong in both legal and practical terms. By establishing a manufacturing facility in Hong Kong that, for example, uses a new, proprietary technology, there is less likelihood that the technology will be copied.

CEPA – service sector

In terms of companies that plan to establish a business in the PRC in the service industry, CEPA also offers certain advantages. Generally speaking, CEPA permits earlier access to the mainland for "Hong Kong Companies"¹⁵ in the service industry ahead of China's WTO commitments. In some cases, such as in the real estate, construction, legal services, and distribution and transport services, it offers concessions that exceed China's WTO commitments.

Certain service sectors will benefit more than others under CEPA. For example, in the area of financial services, asset requirements for Hong Kong banks and insurance companies to enter the mainland market prior to CEPA were US\$20 billion, while under the agreement the entry barrier has been dramatically lowered to US\$6 billion. Moreover, mainland banks will be able to relocate their international treasury and foreign exchange trading centres to Hong Kong. In the retail sector, there has been a lowering of entry thresholds, so that Hong Kong service suppliers can set up wholly-owned retail commercial enterprises on the mainland. Smaller retailers will be able to operate single shops in Guangdong.

Legal services is another area in which there has been marked improvement. Under CEPA, Hong Kong law firms that have set up representative offices on the mainland will be permitted to operate in association with mainland law firms, although these Hong Kong lawyers cannot handle matters of mainland law. Mainland law firms will also be permitted to employ Hong Kong lawyers to practise Hong Kong law. Hong Kong lawyers can sit the legal qualifying examination on the mainland and may practise non-litigation legal work. Additionally, the minimum residency requirement for Hong Kong representatives on the mainland is either waived or shortened to two months each year.

While the CEPA criteria is designed to benefit existing Hong Kong companies, foreign companies considering entering China in restricted areas should carefully consider whether incorporating in Hong Kong (or partnering with a Hong Kong company) has any advantages. Hong Kong's continued integration with the mainland has led to a variety of other measures designed to give Hong Kong individuals and companies superior access to mainland markets and this trend will certainly continue into the future.

Conclusion

The advantages of investing in China through Hong Kong, as described in this article, will affect companies differently, depending on their industry and individual circumstance. Some of the benefits may not seem immediately relevant to a company wishing to establish its operations in China. But even for those foreign companies that only set up Hong Kong holding companies to make their investment in China, one thing is almost certain: if a company is able to take advantage of even one of the benefits set out above, it will more than compensate for the costs involved in setting up and maintain-

ing a Hong Kong holding company.¹⁶

For those who choose to use Hong Kong as their regional base, there are a vast number of additional benefits, including Hong Kong's superb communication and transportation infrastructure, easy access of financing and sophisticated banking services, easy access to a highly skilled workforce (with unrivaled PRC acumen and experience), easy sourcing with a huge supplier and customer base, not to mention its reputation of being Asia's 'world city'.

In either case, foreign companies will find that investing in China through Hong Kong provides ample opportunity for upside with almost no downside.

Notes

- 1 The three original special economic zones were Shenzhen, Zhu Hai and Shantou. These were established in 1980 and are all located in Guangdong Province.
- 2 With over 3,200 regional headquarters, Hong Kong has the largest number of multinational corporate headquarters in the Asia Pacific region (source: HKTDC web site)
- 3 In addition to the three original special economic zones, China has over the years created two more special economic zones, over 40 economic and technical development zones, 14 coastal city zones, over 50 high and new technology development zones, and a variety of other preferential zones. Each of these offers tax and other incentives to foreign companies setting up in China.
- 4 Foreign companies remain limited in the methods they can set up operations in China. The three most common ways of making foreign investment into China (going from the least invasive to the most) are: representative offices, joint ventures, and wholly foreign-owned enterprises.
- 5 The term 'mainland' is commonly used to differentiate Hong Kong from China. Hong Kong and China remain separated by a physical border that runs along the northern part of Hong Kong and both jurisdictions maintain separate customs and immigration systems.
- 6 'One country, two systems' is the structure under which Hong Kong and the mainland were reunified with the purpose of maintaining Hong Kong's unique political and economic systems. Upon the reunification with the PRC, Hong Kong became a special administrative region (SAR) of the PRC.
- 7 The Basic Law, which is similar to a constitution, found in most other countries, was drafted with input from Hong Kong and came into place on 1 July 1997, upon Hong Kong's handover to China. The Basic Law sets out the way in which Hong Kong is to be administered for the 50 years beyond 1997. Under the Basic Law, the Hong Kong SAR enjoys a high degree of autonomy except in matters of defence and foreign affairs. Hong Kong still exercises executive, legislative and independent judicial power, including that of final adjudication.
- 8 Hong Kong is consistently voted the freest economy in the world by the Heritage Foundation.
- 9 China has created a number of special economic zones that have reduced corporate tax rates for foreign companies that operate in those zones, ranging from 15 per cent to 24 per cent depending on the zone. There is, however, increasing pressure on the PRC government to either phase out such beneficial tax rates for foreign companies or at least equalise them so that local PRC companies operating in such zones are also taxed at the lower rate.
- 10 Tax advice should be sought to make with respect to transfer pricing issues.
- 11 Hong Kong does not tax income that is made outside of Hong Kong and has no withholding tax.
- 12 LegCo Panel On Administrative of Justice and Legal Services—LC Paper No. CB(2)248/04-05(05)
- 13 The Pearl River Delta generally refers to China's southern province of Guangzhou and the Hong Kong and Macau special administrative regions of China. It has a combined population of over 80 million people and is by far the wealthiest and fastest growing region in China.
- 14 "Hong Kong Origin" is determined by three tests:
 - Substantial transformation: The 'principal process' has to have taken place in Hong Kong. This principal process test already applies to most products and includes such things as the transformation of yarn to woven or knitted fabrics. The majority of the categories under CEPA (187 of 273) will apply this rule of origin.
 - Content requirement: Under this requirement, at least 30 per cent of the value added must take place in Hong Kong. This test applies to 46 of the 273 categories of goods, which include, for the most part, electronic products such as electric motors, clocks and watches.
 - Change in tariff heading: This test applies when a good is altered in Hong Kong, so that after its transformation it falls into a different tariff heading, as when parts are assembled into a finished product. A total of 40 of the 273 categories of goods will apply this rule of origin.
- 15 Basically, a "Hong Kong Company" is a company that:
 - is incorporated in Hong Kong,
 - pays tax (or is tax exempt) in Hong Kong,
 - has carried on substantial business in Hong Kong for a period of time, and
 - has a proportion of its staff employed in Hong Kong (specific requirements apply to the various service types).
- 16 Other than the cost of maintaining the Hong Kong holding company, there should be little drawback to using a Hong Kong holding company. The costs (including legal fees) associated with opening and maintaining a Hong Kong holding company are low: generally less than US\$2,500 to incorporate and about US\$1,000 annually to maintain.

Goodmans 高文律师事务所

UNIT 1101, 11TH FLOOR
9 QUEEN'S ROAD CENTRAL
HONG KONG
CHINA
TEL: 852 2 522 1061
FAX: 852 2 845 9089
CONTACT: LEO SEEWALD

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